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SUBJECT: UK MORTGAGE LENDERS OK FOR NOW; HOUSING PRICES FALLING

Summary

¶1. (SBU) Recent announcements of lenders withdrawing mortgage products from the market incorrectly suggest that UK mortgage lenders are in crisis. As a group, mortgage lenders are solvent with significant equity cushions in their mortgage portfolios and default rates remain low. Building societies are flush with cash as savers transfer out of equities to deposits. The industry is under stress, however. The liquidity shortage in the general banking sector also affects mortgage lenders that are finding it difficult to meet the demand for new mortgages. Wholesale interbank markets remain essentially closed limiting the funds available for new mortgages. The buy-to-let market for mortgages is effectively shut down. The securitization market remains closed further limiting other lenders' ability to write new mortgages. For more than six months, industry representatives have argued for Bank of England (BOE)intervention to increase liquidity in the mortgage industry in order to meet mortgage demand and slow the rising cost of mortgages. On April 21, the BOE unveiled a GBP 50 billion special liquidity plan that will permit lenders to swap illiquid assets for easily tradable assets. Industry reaction to the plan was positive but cautious, and an industry spokesman said he regrets the lack of greater transatlantic cooperation. It is too soon to assess the new plan's overall impact.

¶2. (SBU) Similar to the U.S., UK real estate values have been rising steadily for over a decade. Amid the global financial crisis and declining economic growth forecasts, UK housing prices have begun to decline. In April, house prices suffered their first yearly decline since 1996, and some are forecasting house price declines of up to 30% over the next few years. The solvency of mortgage lenders as a group is not in jeopardy since mortgage debt currently totals only 40 percent of real estate value due to the long period of escalating prices. Notwithstanding, many argue that continuing declines in house values would adversely affect consumer spending and drag down overall UK economic growth and adversely affect the mortgage industry. End Summary

¶3. (U) In recent weeks, numerous press articles have painted a picture of a deteriorating UK mortgage industry. HSBC projected the number of mortgage transactions in the UK would drop by 30 percent in 2008. The Financial Times reported that the last of 20 banks offering 100 percent loan to value (LTV) mortgages at the beginning of March had withdrawn from the market. On April 9, Halifax reported that UK home values had declined 2.5 percent in February, and the BOE reported April 29 that approvals for new mortgages fell by 11 percent to 64,000 in March.

UK Mortgage Industry Not In Crisis, YET

¶4. (U) Lower growth forecasts and recent property value declines make the outlook for the UK mortgage industry more challenging. However, the industry is not in crisis, Adrian Coles,

Director-General of the UK Building Societies Association (BSA) told Econoffs. He said that the withdrawal of 100 percent LTV loan offerings had little impact since such loans are a very small portion of mortgage lending. Among Building Societies, loans greater than 95 percent LTV have never represented more than 2 percent of lending. Building societies currently are flush with cash as risk-averse customers switch from stocks to savings deposits. Coles said HSBC bank was moving to gain market share in the industry by matching existing terms on mortgage rollovers, albeit only for selected buyers and for a limited time. Michael Coogan, Director General of the CML confirmed the views of Cole. CML members account for 98 percent of all UK mortgage lending, of which BSA members account for about 20 percent. However, Coogan also said that demand for mortgage funds continues to exceed supply, and government intervention was needed to add liquidity to the market. (NOTE: the BOE intervened April 21 with a special liquidity plan - see below).

¶5. (U) Because building societies are flush with cash from new deposits, they are still making mortgages. However, Coles said they traditionally source 25 percent of their funding in the wholesales markets (i.e., interbank market or securitized borrowing), and these sources are effectively closed. Accordingly, while mortgages are available, lenders are being very selective. Coogan added that even BSA members with large deposit inflows were being cautious about increasing lending in the current market where liquidity concerns are paramount.

¶6. (U) Although the overall industry is healthy, there are exceptions. Buy-to-let mortgages,(that is, mortgages to buy properties to lease them out), have largely been discontinued. Coles said Paragon, the second largest UK buy-to-let lender, told him it could no longer raise any money in the wholesale markets and

was effectively out of business for the moment as it offers buy-to-let mortgages exclusively. Also, those that relied on securitization as their principal source of funds, such as GMAC, Lehman Brothers, and Morgan Stanley, have been hit by the shut down of the securitization market.

Mortgage Lenders Are Solvent-But Need Funding

¶7. (SBU) Currently, UK mortgage lenders and building societies in particular are financially sound. Coles and Coogan both said the average mortgage is only 40 percent of value. Even after forecast declines in real estate values, there will be ample equity to collateralize their mortgage books. According to recent statistics from the Financial Services Authority, mortgage arrears also remain low. Repossessions are running below the current CML forecast rate of 0.38 percent (45,000 repossessions). Notwithstanding, the CML has argued for BOE intervention to increase liquidity for mortgage lenders. Without it, the industry argued it could not meet mortgage demand and mortgage costs would spiral upward to ration the available supply.

Government Action

¶8. (SBU) On April 9, Chancellor Darling announced the creation of a Mortgage Finance Working Group (MFWG). http://www.hm- treasury.gov.uk/newsroom_and_speeches/press/2 008. Coles and Coogan both said the MFWG was a positive development. Coles added, however, that it was not clear what the UK government could do on its own to improve the mortgage-backed securities market as a stable source of mortgage finance over the medium and longer term. Further, Coles said, the UK practice of including significant prepayment penalties on 25-30 year fixed-rate mortgages (often 3 - 5 percent) makes it hard to see what the MFWG could do to further its objective of enhancing the supply and demand for them.

¶9. (U) On April 15, PM Brown met with leading UK bankers and heard their concern over the lack of liquidity in the mortgage market. Then, on April 21 the BOE announced details of a special liquidity plan designed to increase liquidity by allowing banks to finance

part of the overhang of currently illiquid assets on their balance sheets. Banks will be able to exchange illiquid assets for up to three years for more easily tradable assets. For details, see the latest BOE Financial Stability Report: http://www.bankofengland.co.uk/publications /fsr/2008/fsrfull0804.pdf

Reaction To The BOE Special Liquidity Plan

¶10. (SBU) Privately, Coogan told Econoff that the CML had cautioned for the past six months that if additional liquidity were not made available, lenders would be forced to ration mortgage lending by tightening lending criteria, increasing price, or withdrawing selected mortgage products altogether. This could exacerbate the decline in property values which would adversely impact economic growth. He also said he believes illiquidity in the mortgage market is an international issue that requires coordinated action by central bankers, including the U.S. Federal Reserve, and there is no indication in the current BOE plan of transatlantic coordination. Publicly, the CML quickly issued a statement welcoming the facility that is expected initially to total GBP 50 billion while reiterating the following cautions. First, the plan will benefit only issuers of mortgage backed securities (MBS). Only five building societies have issued MBS so smaller building societies and specialist lenders will not benefit directly. Second, the plan will increase liquidity, but it is not clear that there is any means of ensuring that lenders will recycle the funds into mortgage products or reduced pricing. The muted industry response reflects uncertainty that it will significantly increase liquidity available specifically to mortgage lenders.

¶11. (SBU) Speaking April 30 at a Debt and Personal Finance All Party Parliamentary Group meeting, Coogan's comments regarding the benefits of the new liquidity plan were less positive than in the initial CML response. He echoed BOE Governor Mervyn King's April 29 comments to the Treasury Select Committee and emphasized that the special liquidity plan is designed to improve liquidity in the banking system, not to support the housing market. Coogan said also that he expects some of the added liquidity will be recycled into the mortgage market, albeit with uncertain timing and scope.

¶12. (U) Regarding the special liquidity plan not being directly available to smaller building societies who do not issue MBS, Sir Callum McCarthy, Chairman of the Financial Services Authority (FSA) testified May 6 to the Treasury Select Committee and said that the FSA had been extensively consulted in developing the current

liquidity plan and he was confident there will be a transmission mechanism to provide small building societies access to the plan. The BOE has not yet reported on usage of the new facility.

Downturn In The UK Housing Market Is Worsening
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¶13. (SBU) Although the UK mortgage market is healthier than many commentators suggest, Coles cautioned that the 2.5 percent decline in property values in February was troubling. The downward trend continued in March, and in April house prices fell below their value a year earlier for the first time since 1996(1 percent below a year earlier according to an April 30 report by the Nationwide Building Society). Coles said that the BSA officially still projects property values will decline by only 3-5 percent in 2008, but he privately told Econoff that he believes values will decline further. Coles said he expects property values will then stabilize but not increase in real terms (net of inflation) for several years thereafter. Like Coles, Coogan said he expects property values will decline farther than most have forecast officially. He said that a 10 percent decline this year was likely. Current funding is the key issue for both Coles and Coogan since with aggregate mortgage debt currently totaling only 40 percent of real estate value, there's plenty of equity cushion to protect lenders.

¶14. (U) Speaking on his own behalf to the Royal Society in Edinburgh on April 29, BOE Monetary Policy Committee member David Blanchflower

said that house prices may drop by a third over the next three years. Separately, the BOE chief economist said he is sanguine about the implications of any fall in house prices for consumer spending, but Coles, Coogan, and others argue that falling home values over an extended period will hurt consumer spending, drag down overall economic growth, and adversely affect the mortgage industry.